Legislative Committee Meeting
June 24, 2008

Return to Work Features and Options – Evaluation Tool

Executive Summary

Allowing retirees to return to work is not a retirement plan design issue, it is an employment issue often created by incentives to retire early, such as "25 years and out", a shortage of qualified applicants for positions, inadequate salaries, etc. Therefore, any pension plan design changes made to accommodate an employment problem should include a sunset, at which time the problem (and solution) can be reviewed, and the impact on the actuarial funding of the System assessed. A report completed in November 2005[1], by the Washington Office of the State Actuary asks the question - Should the retirement system be used as a personnel tool for achieving human resource goals? The report includes the following observation regarding the issue of "retire-rehire:

> "Perceptions of retire-rehire vary and opinions run deep. Public sector programs involving the re-employment of retirees are more sensitive than those in the private sector because of the perceptions they generate and their potential impact on taxpayers. Proponents of post-retirement employment argue that once a retirement benefit is earned, it should not matter whether the retiree returns to work with the same employer or whether that retiree works while drawing a pension. Opponents believe that drawing a public pension and earning a salary at the same time is "double dipping" and not retirement. As a philosophical matter, the retire-rehire debate gets to the very purpose of retirement – that is, whether a retirement pension is to provide income security to those leaving the workforce, or whether it is a reward for completing a determined number of years in a career."

We spoke with 16 State Retirement Systems with membership ranging from teachers and administrators, all school personnel, educators and state employees, to systems that cover all public employees. The goal of the survey was to identify a range of different options and features used by various systems to allow retirees to return to work. Our goal was not to identify the perfect system or to even find a plan we could emulate. I trust the Committee's work will provide them with a list of options and ideas that they will be able to use to craft a unique proposal for Montana TRS that will allow retirees to return to work, but also will not have an adverse impact on the actuarial soundness of the System.

One of the goals of the study completed by the State of Washington was to determine the cost of their retire-rehire program. The conclusion of the study was

[1] Post-Retirement Employment Program Report by the Washington Office of State Actuary is available at:
http://osa.leg.wa.gov/Actuarial_Services/Publications/PDF_Docs/Pension_Studies/2005_Post_Ret_Empl_Rpt.pdf

that the retire-rehire program had an effect on retirement behavior. The study found members were retiring earlier, and that earlier retirement has a retirement system cost. The challenge to the Committee will be to keep retirement behavior changes to a minimum and to fund or find saving that will offset any increased costs. The 2007 Actuarial Valuation estimated that the cost of benefits if all members retired as soon as they were eligible for full benefits could increase by around 3.45% of payroll.

Current law, §19-20-731, MCA, applies to all retired members returning to work for K-12, State Agency, and University employers. One of the first questions the Committee will want to ask is - Do they want to recommend any changes to the TRS Board? Secondly, if the Committee decides to recommend changes, they will need to decide before the September Board meeting if they want to apply different rules to retired members hired by a State Agency or Unit of the University System. However, any proposed changes could only affect employment contracts executed by retired members after the effective date of any legislation.

Half the Systems surveyed required employers to make a contribution (fee) on wages paid to rehired retirees. Although we suspect that the number of rehired retirees has been under reported, historically between 500 and 600 retirees are reported to TRS each year as returning to part-time employment (809 on June 2008 working retiree report). Had TRS collected contributions on compensation paid to these retirees over the past four years, we would have collected around $1.1 million per year. If the retire-rehire program were to be expanded and employers were required to contribute on all wages paid to these retirees, we could expect this number to increase because of the likelihood that more retirees would be working full time. However, unless the program is opened up to encourage members to retire-rehire, we would not expect a significant increase in the number of retirees working full time.

A cost neutral design can possibly be accomplished through a combination of the options. (This is not intended to be an exhaustive list of the options available.)

- collecting contributions on all wages paid to working retirees
- Reduce future benefits dollar-for-dollar (or another multiple such as one dollar for every three or five dollars earned) for any amounts earned over the 1/3 earnings limit
- limits on returning to work for the same employer
- not allowing retired members to return to active membership
- increase the waiting period before a retiree could be rehired
- eliminate subsidies that encourage early retirement

In addition, any change must include a sunset at which time the Actuary can assess if the new features have had any adverse impact on the TRS, and then give the Legislature an opportunity to continue the program or let it expire. Once the TRS Legislative Committee has identified their preferred list of program changes, we will ask Tax Counsel and our Actuary to review the proposal for any IRS compliance issues or potential adverse funding concerns. We will also ask Legal Counsel to further review the issue of contract rights for re-employed retirees through the use of a sunset clause. However, this would not be the first time we have used a sunset clause to avoid creating long term contractual rights for rehired retirees.

We must also keep in mind that the Internal Revenue Service (IRS) has issued new regulations prescribing the conditions under which a qualified plan may make distributions. In those regulations, the IRS makes it very clear that qualified pension plans cannot make a distribution without a bona fide separation from service except in very limited circumstances. (This requirement has been in place since 1956.) In addition, federal tax law, IRC, Section 72(t), generally imposes a 10% tax penalty on distributions to retirees who are less than 59½ unless there has been a bona fide separation from service or the retiree is normal retirement age, disabled, or dies.

The IRS regulations permit the pension plan to make distributions without a bona fide separation from service if the retiree has achieved normal retirement age as specified in the plan. The regulations provide that a plan may designate as normal retirement age any age of 62 or higher as a “safe harbor”. For a general population (TRS plan), a plan can provide for a normal retirement age of between age 55 and 61 so long as it can be demonstrated that the normal retirement age that is established is not earlier than the earliest age at which employees in that “industry” normally retire. If a qualified plan permitted in-service distributions at an age that is lower than the appropriate normal retirement age, such distributions could affect the qualified status of the plan.

In order to have a bona fide separation from service under federal law, there must be a cessation of the employment relationship between an employee and the employer. This also means that there cannot be a prearranged agreement prior to separation from service for that employee to return to employment with the same employer at any time in the future after retirement. A prearranged agreement to be reemployed could also include reemployment as a leased employee or as an independent contractor. The IRS focus is on reemployment with the same employer in any capacity, not on reemployment with a different employer. The IRS also does not recognize a change in employment status (such as going from full to part-time or going from a TRS covered to a non-covered position) as separation from service so long as the same employer is involved.

While the IRS has refused to rule on what period of time constitutes a bona fide break in service, the State of North Carolina (2005 study[2]) indicated that IRS representatives have stipulated orally that a two-month separation of service would likely not meet their requirements. The explanation is that a leave of that or similar duration might be considered equivalent to, or indistinguishable from, a summer leave, which is customary for certain occupations; educators for example. A two-month leave therefore may not be an indication of genuine separation from service for teachers.

[2] The North Carolina report is available at: http://www.nasra.org/resources/NC%20Return%20to%20Work%20Study.pdf

Return to Work Strategies/Options

The following lists several options/features that we identified in our review and survey of what other States are doing relative to retire-rehire. Several of the features found in other States could increase unfunded liabilities and/or become overly administratively burdensome if adopted by the Committee. It is the goal of the Legislative Committee to decide what if anything they want to recommend to the Board when they meet in September.

1) Break In Service

The Montana TRS requires retired members to have received at least one monthly retirement benefit before they return to work in a part time capacity. Our survey results show that other States require a break in service ranging between 30 days and 1 year. Also the required break can vary depending upon if the retired member is returning to work for the same employer, is an administrator, as an independent contractor, or full-time.

Does the Committee want to recommend increasing the required break in service? Some of the features found in the plans we surveyed included:

- **a)** Requiring a longer break if a retiree returns to a full-time position (e.g. 120 days or more, more than half time, etc.)
- **b)** Require a longer break in service if returning to work for the same employer, with exceptions for substitute teachers, or for employment of less than 3 months, or 5 months, etc.
- **c)** Require a longer break in service if retiring early, i.e., before age 60, or with less than 25 years of service

2) Returning to work with the same employer

There are currently no restrictions on a TRS retired member returning to work for the same employer, if the member retired on or after “normal retirement age”. However, if a member is retiring early, i.e., with less than 25 years of service, and less than age 60, they cannot have a prearranged agreement to return to work with the same employer and must have received at least on retirement benefit, §19-20-731, MCA.

Does the Committee want to recommend imposing any restrictions on returning to work for the same employer? Some of the features found in the plans we surveyed included:

- **a)** Require that there be no prearranged agreement, verbal or in writing, to return to work for the same employer for members who are normal retirement age as well as early retirees

b) Require a longer break for administrators than teachers, or not allow administrators to return to work for the same employer
c) Reduce benefits if they return to work for same employer, e.g., 5% per day
d) Different earnings limits if they return to work for the same employer, e.g., instead of 1/3, maybe limit to a dollar amount or social security limits
e) Longer break in service, up to one year if they return to work for the same employer
f) Exceptions for substitute teachers, fill in for extended military deployments, maternity leave, and others working for very short periods of time
g) Limit rehire opportunities with the same employer if the retiree received a retirement incentive

3) Limit compensation a retiree can earn and still receive monthly benefits

Current law limits re-employed retiree's compensation in a part-time position to the greater of 1/3 of their Average Final Compensation (AFC) plus annual CPI increases, or 1/3 of the median AFC for all retirees retiring in the preceding fiscal year. Effective with contracts executed on or after July 1, 2007, the limit on compensation received by rehired retirees includes most fringe benefits, such as housing and car allowances.

Does the Committee want to recommend changing the earnings limit? Some of the features found in the plans we surveyed included:

a) Limited to a specific dollar amount, could be tied to social security earnings limit, or to current member's salary such as, ½ the average salary paid to an active TRS member
b) Smaller limits if returning to same employer
c) Limit based on years of service, e.g., 75% if 30 or more years of service, 65% if less than 30 years
d) Different or no limits in critical shortage positions
e) No limit at all

If the Committee wants to continue with a dollar limit, how should any earnings in excess of the limit be treated? Some of the features found in the plans we surveyed included:

f) Terminate benefits and reinstate the retired member to active contributing status (current TRS law)
g) Reduce future benefits dollar-for-dollar (or another multiple such as one dollar for every three or five dollars earned) for any amounts earned over the limit
h) Terminate benefits for the remainder of the year in which they exceed the limit

4) Limit number of hours or days a retiree can work and still receive monthly benefits

Current law limits re-employment to part-time positions. Effective with contracts executed on or after July 1, 2007, part-time service is defined as less than 140 hours per month for 9 months, or less than 180 days in a fiscal year.

Does the Committee want to recommend changing the part-time employment requirement? Some of the features found in the plans we surveyed included the following. (Often these limits included different or no dollar limits on the wages a rehired retiree could earn.)

- **a)** No limit on the number of hours or days a retiree could work and continue to receive retirement benefits
- **b)** Allow retirees to return to work full time, if age 65 (Mark Olleman addressed this feature in his letter dated January 25, 2008)
- **c)** Different or no limits in critical shortage positions
- **d)** Allow retiree to work full time for a limited period of time, such as 19 weeks, and then require that they work only part time
- **e)** Allow retirees to work full time, but limit wages paid to a retiree by a school district for any position. For example. A retired member could be employed in a full-time PERS position, but would be subject to the 1/3 earnings limit
- **f)** Create a cumulative lifetime maximum number of hours a retiree could work before they are restricted to part-time employment, e.g., hours worked each year between 867 and 1,500 counted toward a 1,900 lifetime limit, after which the retiree was limited to working 867 hours per year.

5) Employer contributions on all wages paid to a retired member returning to work

Currently employers do not contribute to TRS on wages paid to a retired member working part time and subject to the 1/3 earnings limit. Had employers been required to contribute to TRS 17.11% of all rehired retiree's wages over the past four years, we would have collected around $1.1 million per year. Unless the program is opened up to encourage members to retire-rehire, we would not expect a significant increase in the number of retirees working full time.

Does the Committee want to recommend that employers contribute to TRS on all wages paid to rehired retirees? Some of the features found in the plans we surveyed included:

- **a)** Require employers contribute the combined contributions rate (17.11%) on all salary/wages/compensation paid to retired member regardless of the number of days or hours worked.

b) Require employers to contribute on all salary/wages/compensation paid to retired members employed full time

c) Require employers make contributions only after a retired member has been employed for a certain number of hours, days or months

6) Forfeit benefits and return to active status

Current law allows a retired member to forfeit benefits and return to active contributing status. When the member subsequently retires, benefits are recalculated as if the member had never drawn a single retirement benefit from TRS.

Does the Committee want to recommend any changes to the return to active status policy? Some of the features found in the plans we surveyed included:

a) Do not allow retired members to return to active status, e.g., work full time and receive full or reduced benefits

b) Require they forfeit benefits if they exceed either the wage and/or hour limits

c) Do not allow retired members to return to active status, but suspend benefits for the remainder of the year

d) Allow retirees to receive benefits, and contribute into a second account from which they will receive an additional benefit when they terminate

7) Calculation of benefits following return to active status

When a retiree returns to work, benefits are canceled and a new benefit is calculated when he/she again retires. This re-calculation can result in a benefit increase that is often underfunded.

If the Committee chooses not to recommend any changes to current policy allowing retirees to return to active status, does the Committee want to recommend any changes to the way benefits are recalculated when a rehired retiree subsequently retires? Some of the features found in the plans we surveyed included:

a) Suspend current benefit, and calculate a second benefit when the member retires again, if they work for at least a given period of time, typically one to five years. If they do not work the required number of years, employee contributions, plus interest, would be refunded and the original benefit reinstated with or without cost of living increases

b) Calculate an annuity using the new employee and employer contribution less the UAAL percentage, plus interest

c) Recalculate the benefit and then actuarially adjust for benefits already received

d) Do not allow rehired retirees to change retirement option or beneficiary when benefits are recalculated

8) Return to work agreements with the same employer prior to termination

Current policy does not require any formal certification; however, current law does require an “early” retiree to have a bona fide separation of service, which means there must be a break in service and there cannot be any prearranged agreement to return to work for the same employer. In order to implement the IRS requirement for a bona fide separation from service, some retirement systems require that the retiring member and their employer must certify at the time of application for retirement benefits that there is no prearranged agreement to reemploy the retiring member.

If the Committee did not restrict re-employment with the same employer (No. 2 above), does the Committee want to recommend that employers and the retiring member complete a form certifying that there was, or was not a prearranged agreement to return to work? (We have several examples we could use to build a form.)

Features and/or options found in the plans we surveyed included:

- **a)** Maintain current procedure, which requires staff to follow-up with employers when we suspect that a prearranged agreement to return to work would prohibit payment of benefits or require tax Form 1099-R to be coded as a premature distribution
- **b)** Require employers and members to certify if they do, or do not, have a prearranged agreement to return to work. If a member qualified for “Normal Retirement”, no action would be taken by the TRS. If they did not qualify for Normal Retirement, IRS rules could either prevent us from paying the benefit if an “Early Retirement” or the individual may be subject to an additional 10% premature distribution tax

9) Independent Contractors

Administrative Rule, 2.44.308, states that certification from the Montana Department of Labor and Industry as an independent contractor shall be accepted as prima facie evidence of independent contractor status. In absence of certification by the Department of Labor and Industry, it must be shown that the worker is both free from direction and control of the party utilizing their services and have an independently established business.

Does the Committee want to recommend any changes to the Board? Some of the features found in the plans we surveyed included:

- **a)** Require all Independent Contractors meet the 20 point test of the Internal Revenue Code, IRS ruling 87-41, 1987-1 C.B. 296

b) Require employers contribute on amounts paid to retired member working as an independent contractor
c) Subject amounts paid to a retiree working as an independent contractor to the System's return to work wage or hour/day limits

10) Other features or design options

Some of the other features we found included:

a) Allow retirees to return to work full time for a short period of time, e.g. 5 months, 12 months, 36 months, etc.
b) Allow retirees to return to work full time in critical shortage positions
c) Require that retired members be rehired through the "normal competitive hiring process"
d) Require employers to have a written policy that documents both their hiring process and justifies need for hiring retirees
e) Allow retirees to receive partial benefits (50%) and work full time
f) Sunset and monitor the return to work program to ensure the TRS is not adversely affected